

# The Creation of a Market for Retail Electricity Supply

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## Abstract

In September 1989, as part of its privatization program, the Government laid down an eight year timetable for opening up to retail competition the entire electricity market of England and Wales, phased over the period 1990-1998. It might be assumed that the Government was in a position to specify all the arrangements, and that this was part of a considered policy to facilitate the introduction and implementation of competition. But previous accounts suggest that the outcome was part of a deal between generators and regional companies to limit competition (Henney 1994), or was intended to set targets to force companies, regulators and government to come up with practical solutions (Helm 2004). The Department of Energy's internal History of Electricity Privatisation, only now available, shows that there is merit in these last two suggestions. However, it also documents the significantly evolving views within Government as the implications of retail competition became clearer, not least for electricity contracts and for privatization of the coal industry. Initially, retail competition was hardly worth mentioning, later it was a mild concern that could be met by a small tranche of spot-price contracts, by July 1989 the plan was to introduce full competition immediately with short-term instead of long-term contracts. But the industry resisted, and in September 1989 the Government accepted the industry proposal of a franchise monopoly to enable a mix of short, medium and long-term contracts, though it insisted that the franchise should have an eight year limit. The approach may not be a model for others, but it may not be atypical of how governments actually behave in balancing conflicting objectives and practical constraints, save perhaps for the distinctive commitment to competition exhibited by the leading actors here.

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# The Creation of a Market for Retail Electricity Supply

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## 1. Introduction

Until 1990 UK electricity supply was provided by state-owned entities with regional monopolies. A retail electricity market (sometimes called supply competition or retail choice in the US) did not exist; even the concept was alien. Yet in September 1989, as part of its privatization program, the Government laid down a timetable for opening up to retail competition the entire electricity market of England and Wales. There were three stages: large users on 31 March 1990 (Vesting Day), medium-sized users in April 1994 and all other users including domestic (residential) in April 1998.

The response was dramatic. In April 1990 about one third of the largest business users in the country chose a different electricity supplier. By 1997/8 the proportion had roughly doubled. In April 1998 the smallest (residential) users were allowed to choose supplier. By April 2009 over half had changed supplier. Other countries have followed suit. Full retail electricity competition (that is, choice of supplier for all customers regardless of size) is now official policy in the European Union.

It might be assumed that the way in which the market was created in England and Wales was part of a considered policy to facilitate the introduction and regulation of competition; that the Government as owner of the nationalized electricity industry would be in a position to specify the precise arrangements for opening the market; that the phasing over time was designed to facilitate implementation; and that the contractual arrangements that accompanied the timetable would provide a basis for the future development of the industry. It might even be thought that this would be a model case study of how governments can successfully create a competitive market. Certainly, other countries have generally phased in the opening of their own retail electricity markets.

Two accounts of electricity privatization paint a rather different picture. Henney (1994) says that the Regional Electricity Companies (RECs, formerly known as Area Boards) agreed a deal with the generators whereby competition would be limited to very large customers.

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\* Emeritus Professor, University of Birmingham; Fellow, Judge Business School, University of Cambridge. An earlier version of this chapter was presented to the Workshop on "Manufacturing Markets: legal, political and economic dynamics", Villa Finaly, Florence, June 11-13, 2009. I am grateful to conference discussants Carine Staropoli and Yannick Perez; to Michael Brocklehurst, Paul Kitcher, David Walker and George Yarrow for clarifying pre-privatization arrangements; to John Baker, Willy Rickett and Lords Lawson, Parkinson and Wakeham for further insights; to several referees; and to Jean-Michel Glachant for editorial suggestions.

“Leaving the obligation to supply to market forces would not ensure that sufficient capacity would be built ... This arrangement would ensure that the proposed nuclear plants could be built, and that everyone would be spared the inconvenience of having to compete.” (p. 116)

The Department of Energy rejected this deal, but agreement was reached later on the timetable mentioned above, with an associated set of long-, medium- and short-term contracts between the RECs and the generators.

Helm (2004) suggests that “the concept and design of the transition to full retail competition was an article of faith rather than a well-worked out plan”. In the event it provoked a series of crises for all the parties:

“Why, then, did its architects pick such a rigid timetable in ignorance of its practicality? Although there was a strong dose of cynicism in fixing dates which were carefully designed to be beyond the successive general elections, there was a clear rationale behind the plan....The role of the deadlines is to give companies (and regulators) targets. ... The industry then had to be bound to the mast of an ever more liberalised market, with companies, regulators and government forced to come up with solutions, or face the criticism which inevitably follows delay.” (pp. 152-4)

The extensive *History of Electricity Privatisation* (Department of Energy 1992), only now available, enables us to evaluate the above propositions.<sup>1</sup> The *History* contains a frank and detailed account of advice given by the Department of Energy [henceforth the Department] to its ministers, and of exchanges of view between senior ministers, the Prime Minister and other parties involved.

As we shall see, the *History* suggests that actual events were almost the opposite of the first picture painted above. In many respects they were consistent with the accounts given by Henney and Helm, but the *History* reveals a richer picture, of thinking and plans that evolved very significantly over time, as the Government gradually came to terms with the implications of retail competition and recognized the limitations of what it could deliver. It documents (from sources not available to the other authors) not only the evolving views within the Department but also the differing views and influence of other ministers and advisers.

This paper focuses on the creation of a retail electricity market, one of the least understood yet most controversial aspects of electricity privatization. I have sought to put the concept into a slightly broader historical and academic context than other authors, and to bring some personal perspective to bear.<sup>2</sup> Nonetheless, it will be apparent that retail competition cannot be considered as an isolated part of the novel competitive electricity market that was created around 1990, nor of the Government’s economic and political strategy as a

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<sup>1</sup> Unless otherwise indicated, the numbers in parentheses refer to paragraphs in this *History*. The relatively few redactions in the public version of the *History* do not impinge on the narrative and analysis of the present paper. David Parker’s *Official History of Privatisation*, Volume II, 1987-1997, which will cover electricity privatization, is still in course of writing.

<sup>2</sup> The author played a small part in this story, initially as adviser to the Secretary of State from November 1987, and then (from 1989-1998) as the first electricity regulator. He was also an early proponent of the concept of retail competition in electricity supply (Littlechild 2009).

whole. For convenience, a timeline of relevant events is attached at the end of the paper.

## **2. Background**

The Electricity Act 1947 nationalized the electricity industry in Great Britain. It created a British Electricity Authority and 12 Area Electricity Boards in England and Wales (plus 3 in Scotland). The Electricity Act 1957 replaced the British Electricity Authority by the Central Electricity Generating Board (CEGB).

The CEGB was required to develop and maintain an efficient, co-coordinated and economical system of supply of electricity in bulk to all parts of England and Wales. To that end it generated almost all the electricity it needed (supplemented by a small proportion imported from Scotland and France) and transmitted it, through its high voltage power lines and cables, to the Area Boards.

The 12 Area Boards bought bulk supplies of electricity from the CEGB. Each Area Board distributed electricity to consumers in its own geographical area, where it had a statutory monopoly. The CEGB was allowed to supply electricity to any other body if authorised by the Minister, though such direct supply was not used on a significant scale. It was open to a large industrial user to generate its own electricity, but there was no wholesale or retail market for electricity, and no concept of competition in retail supply.

## **3. Early views: 1979 to 1987**

A new Government brought a new approach.

The Conservative administration of 1979 set out to reverse the policy of centralised public sector planning. In 1982, the Secretary of State for Energy [Nigel Lawson] set out the new objective: to create a market for energy. The Oil and Gas (Enterprise) Act 1982 sought, inter alia, to liberalise the gas market and, in particular, to provide for competition through common carriage. The Energy Act 1983 extended the same principles to the electricity supply industry. (1.02)<sup>3</sup>

Although important forerunners of privatization, the 1982 and 1983 Acts were nonetheless limited in effect (Hammond et al 1986, Helm 2004 p. 64).

In initial thinking on privatizing and liberalizing the electricity industry, two major and influential views emerged. As the *History* remarks, they were to recur throughout the debate on the future structure of the industry.

- A study by consultants Coopers and Lybrand (1983) in May 1983 concluded that the only scope for introducing competition lay in generation, and saw a breakup of the CEGB as the only means of

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<sup>3</sup> This principle of common carriage was being developed elsewhere too, including in Chile. But neither Chile nor the Energy Act 1983 envisaged retail competition for all customers as an alternative (or complement) to regulation of electricity or gas supply.

achieving this. It identified the nuclear program as the main obstacle to this. It assumed that long-term contracts with Area Boards that continued to have a monopoly of supply would ensure sufficient investment in new generation. (1.04-1.08)<sup>4</sup>

- Sir Walter [later Lord] Marshall, chairman of the CEBG, took a quite different view, also in May 1983. He resisted breakup of the CEBG and favored amalgamating the Area Boards into a single distribution company (the so-called 'two-company solution'). He "saw no advantage in licensing the Area Boards' territorial monopoly", and envisaged the CEBG effectively competing with this Board in supply to large users. (1.09)

By 1983, the Treasury, now under the leadership of Nigel Lawson who had moved there from the Department of Energy, was actively taking forward the development of policy on privatization and competition generally (Parker 2009, pp. 172-177). It commissioned a paper that contains what seems to be the first suggestion of retail competition for *all* electricity customers (Littlechild and Beesley 1983; see also Parker 2009 p. 175 fn 64, Littlechild 2009).<sup>5</sup>

In contrast, Peter Walker, the new Secretary of State at the Department of Energy, was of a different disposition to Nigel Lawson. He privatized British Gas as a single entity in 1986, which did not take forward thinking or practice on competition (Helm 2004 pp. 108, 116, citing Hammond et al 1985a, see also Hammond et al 1985 b). The Department's report to the Secretary of State in April 1987 "cast doubt on the competitive benefits of fragmenting the industry" and noted considerable support within the industry for the 'two company' solution". (2.10) Inter alia, "independent generators should continue to have the right to supply customers direct, but the option of restricting this right to large customers should be seriously considered, as should be the possibility of preventing the CEBG from supplying direct". (2.12)

In March 1987, Henney (1987) argued for breaking up the CEBG into nine or ten successor generating companies and a separate grid company. He proposed that there should be competition in supply for large (but not small) electricity users, using the distribution network as a common carrier.<sup>6</sup>

A Department paper identified many difficulties that Henney's restructuring proposal would raise and the time it would take (nearly ten years, covering two

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<sup>4</sup> The study was commissioned by Nigel Lawson, who refers approvingly to it in his memoirs (Lawson 1992 p. 179).

<sup>5</sup> I discussed the electricity part of this paper with some industry contacts in December 1983, and then expanded it into a separate paper on electricity privatization (Littlechild 1984). Amongst other things, these papers proposed to separate the electricity Area Boards into distribution networks and competing private retailers that would buy and sell power over the distribution networks. This would make new use of common carrier obligations on the distribution networks. The aim was to use competition rather than regulation to pass through to retail customers as a whole the increased efficiencies in generation (that we expected would flow from privatization, competition and new entry into the wholesale market).

<sup>6</sup> Henney (1987 p. 40) suggested that customers taking more than 0.25m kWh per annum should be able to choose their supplier. At a typical load factor of 57 % this would correspond to a maximum demand of about 500 kW (= 0.5 MW). This would represent the largest 20,000 or so out of some 22 million customers, accounting for about [40 %] of total demand.

Parliaments). It “expressed worry about the disruption caused by such a long drawn out process, especially for the large investment programme in generating capacity that was foreseen”. (2.14)

A meeting with the Prime Minister on 28 April 1987 concluded that electricity privatization was feasible, but reached no conclusions on the appropriate option. The election was called for 11 June 1987. The Conservative manifesto contained a commitment ‘to bring forward proposals for privatizing the electricity supply industry subject to proper regulation’. It also said that a Conservative Government intended to go on playing a leading role in the task of developing abundant, low-cost supplies of nuclear electricity. (2.18)

#### **4. Exploration of options: June 1987 to February 1988**

Following the election, Cecil Parkinson was appointed as the new Secretary of State for Energy on 13 June 1987. The day after taking up his post he discussed a Department paper on the options for electricity privatization. It was agreed that further work should concentrate on the ‘two company’ option (which was subsequently dropped) and the break up of the CEBG. Financial, technical, legal, regulatory and accounting advisers were to be appointed. Further discussions among the Department, its advisers and the industry, and a seminar presentation to the Prime Minister and other leading ministers at Chequers (the Prime Minister’s official country residence) on 14 September 1987, explored the implications of four main options:

- Option A privatize the CEBG as it stood
- Option B as for Option A, except that a block of power stations would be sold off as a competing company
- Option C as for Option B, except that ownership and control of the grid would be transferred to the distribution companies;
- Option D as for Option C, except that the CEBG would be broken up into four or five generating companies.

All these options assumed the privatization of the Area Boards as existing separate entities. (3.15)

The Chequers seminar agreed that Option A should be ruled out, and that options C and D should in particular be studied, though option B could not be ruled out. Major issues for study included the feasibility of separating the grid from the other CEBG generating stations, the implications for the nuclear investment program, for coal, for prices and for Scotland, and the possibility of privatizing the industry in one Parliament rather than two.<sup>7</sup>

After further analysis and discussions, the Secretary of State held a weekend seminar at Nuneham Park on 21/22 November 1987. The seminar explored in turn the options earlier presented to the Prime Minister. There was still

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<sup>7</sup> Cecil Parkinson adds that it was also decided to include nuclear in the package, and that the ongoing nuclear programme must proceed. “Finally, it was agreed that if there was a conflict between introducing competition into the industry and getting the best price for it then competition should take precedence over price. Nigel Lawson [Chancellor] ... was particularly insistent on this.” (Parkinson 1992 ch. 13, cited in Henney 1987 p. 59)

considerable pressure from the CEBG for option A.<sup>8</sup> Nevertheless, the Secretary of State decided that his tentative preference was option C, given the political imperative to introduce competition into the industry. Option D was envisaged to involve too much disruption and to take two Parliaments to complete.<sup>9</sup>

There was subsequent analysis of how to produce the desired level of new nuclear investment, which was in doubt under any of the options. Possibilities included retaining nuclear in the public sector, subsidizing the building of nuclear plant, and imposing some form of obligation on generators or distributors to generate or take X% of electricity from non-fossil sources. This was not a trivial issue, particularly for the Prime Minister, who “expressed great concern about the future of the nuclear program and skepticism that a statutory obligation on the Area Boards would work”. (3.41)

There were still differences of view among ministers, with the Chancellor and the Trade and Industry Secretary favoring something closer to option D. The Prime Minister too had concerns about structure, and “was at first not prepared to accept that privatization should proceed on a basis opposed by Lord Marshall”. (4.01).<sup>10</sup> These issues were not resolved until a Cabinet Meeting on 25 February 1988. And indeed important new issues began to surface, such as the potential impact of coal imports on British Coal. (4.06)

## **5. The *White Paper* February 1988 and competition in supply**

The *White Paper* entitled *Privatising Electricity* (Secretary of State for Energy 1988) was published on 25 February 1988, after the Cabinet Meeting just mentioned. Effectively, it announced the decision in favor of option C. Two privatized generators would be formed from the CEBG, with the larger one owning some 70% of existing capacity including the nuclear stations, and the smaller one owning the remaining 30% of existing capacity. The transmission grid would be separated off, and owned jointly by the distribution companies. The two successor generating companies were known as Big G (later National Power) and Little G (later PowerGen).

The *White Paper* discusses the strengths and limitations of the existing industry structure, the proposals for restructuring and competition in generation, the need for nuclear power, and the implications for regulation, customers and employees. It says that customers should be given new rights. But at no point in

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<sup>8</sup> “Lord Marshall had told the Permanent Secretary that most, if not all, of the Board of the CEBG would resign if any decision was reached that did not leave the CEBG intact. ... The Permanent Secretary informed the Secretary of State of Lord Marshall’s message in the margins of the seminar.” (3.30) I have been told that Lord Marshall’s Board colleagues were not aware of his message.

<sup>9</sup> The Nuneham Park seminar was my own introduction to the scene. (3.26) I regret that it did not present the Secretary of State with a feasible and defensible option for a competitive industry structure. The *History* does not indicate that the four or five successor generator companies in option D would jointly own the nuclear generating stations and would be precluded from subsequently divesting (or specialising in) this nuclear ownership.

<sup>10</sup> She had appointed him Chairman of the Atomic Energy Authority in 1981, Chairman of the CEBG in 1982, knighted him later that year, and made him a life peer in 1985 “on successful completion of his crusade to ‘keep the lights on’ no matter what moves Arthur Scargill’s striking miners made against the power stations” (Baker 1996). See also Thatcher (1993 pp. 683-4).



this period of policymaking – that is, from the election in June 1987 to the *White Paper* in February 1988 – does the *History* mention the concept of competition in supply (or retail competition or choice of supplier). There is no discussion of the implications of generators being able to sell direct to customers, whether large users or others. An influential view in the Department was that this would not be of interest to suppliers or any but the very largest users (Littlechild 2009 p. 2) There was also concern that it could prejudice the delivery of some of the policy objectives, such as securing value from the sale of the industry (proceeds) and timely completion of the privatization within the lifetime of the 1987 Parliament.

Although I pressed for some explicit recognition of the potential importance of competition in supply, the emphasis in the *White Paper* was on restructuring to create competition in generation, with a focus on the privatized Area Boards driving the competitive action by seeking out competitive tenders. There was reference to “other existing and potential private generators, who will generally contract with the distribution companies, the grid company, or large customers”. But with respect to competition in supply, there were only a few sentences about distribution companies competing for large users, possibly using common carriage.

The *White Paper* included a commitment to strengthening the common carriage arrangements, which it recognised as an important area for regulation. It also acknowledged the need to ring-fence the various activities of the privatized companies, together with separate accounts. So there was an emphasis at this stage on putting in place the conditions necessary to make competition in supply effective. And the regulator would have a duty to promote competition. But such competition was still regarded as a matter for large users, and was not regarded as unduly significant, let alone as a threat to privatization.<sup>11</sup>

The *White Paper* asserted that, “in the new structure, the commercial relationship between the distribution companies and generators will be governed by contracts”. (p. 8) Thus, “the grid company will operate on the basis of contractual relationships with generating and distribution companies”, which “will be for them to negotiate”. It was left open whether the distribution companies would contract for supply from the grid company (analogous to the single buyer model), or from the generating companies, or from both. But the statutory obligation to supply would be placed on the distribution companies rather than on a generator. (The Area Boards and the Department consistently maintained that the latter would prevent competition from developing.)

## **6. Regulation and Competition in Supply**

The Department put a paper to the industry in March 1988 setting out proposals for the broad structure of regulation. It noted that “The monopoly areas of retail supply and transmission would need to be regulated”. (7.01) Thus, at this stage

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<sup>11</sup> “Even after privatisation, the supply activities of the distribution companies ... will remain, in large part, natural monopolies.” (*White Paper* para 50).

no distinction is drawn between distribution and retail supply, and retail supply is assumed to be a monopoly rather than a competitive activity.<sup>12</sup>

Four months later, some of the implications of retail competition began to dawn. For example, the *History* now refers to an “Alternative Approach to Price Formula”, namely the argument that I had been making for separate and different types of price controls on distribution and supply businesses rather than a single price control. (7.20)

And for the first time the *History* has a subheading with the phrase ‘Competition in Supply’:

The new structure of the industry seemed likely to create more competition in electricity supply than was envisaged in the White Paper: there would be no permanent monopolies of supply; and the distribution companies’ ownership of their wires would give them a natural monopoly of distribution, but not of supply.

Competition in supply faced the distribution companies with the risk of ‘stranded investment’. The proposed regime dealt with this problem in two ways:

- large customers would be obliged to take supply on contract, rather than by tariff. The contracts could contain suitable exit clauses to deal with stranded investment;
- in deciding whether to grant a second-tier licence to an alternative supplier, the regulator would need to take account of the impact on the distribution company of stranded investment. (7.11, 7.12)

It would soon become apparent that this was an optimistic assessment as a result of the limited interpretation of the stranded investment issue, and of the concept of retail competition.<sup>13</sup>

## 7. Decisions: February to December 1988

The *History* refers to the period leading up to the *White Paper* decisions as the ‘political’ phase. Next, from February to November 1988 came the ‘creative’ phase: “the ground-breaking work on regulation, licences and contracts, the initial attempt to square nuclear liabilities with privatization”, culminating in the

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<sup>12</sup> Nevertheless, in some respects the Department seemed to be thinking boldly. Henney (1994 p. 94) says that although the Area Board chairmen “were aware that the White Paper talked of competition to supply large customers, they were very surprised at the first meeting of the Joint Department/REC Regulation Working Group in March 1988 when the Department said that the entire market would be open to competition”.

<sup>13</sup> It was expected that each ‘alternative supplier’ would have a license to supply ‘defined premises’ (7.08). The initial licenses did indeed list the specific customers that the Secretary of State allowed each company to supply beyond its own area, and the companies had to apply for approval to serve other customers. One of my earliest actions as regulator was to remove the need for this, by granting licences enabling the recipients to supply any customer with maximum demand over 1 MW (Littlechild 2000, pp 24-5).

introduction of the Electricity Bill. From then until Vesting was the 'executive' phase.

An early decision (in March 1988) was the timetable for privatization, beginning with Vesting Day (when the restructuring of the industry and the new regulatory arrangements would take effect) on 1 January 1990.<sup>14</sup> On 9 June 1988 the designate chairmen and chief executives of the CEGB successor companies were announced. On 17 June the CEGB proposed an allocation of power stations between Big G and Little G successor companies. Some new appointments were made to the boards of the Area Boards, especially finance directors. Plans for a new Office of Electricity Regulation (Offer) were developed by September 1988. My appointment as Director General of Electricity Supply (DGES), and head of Offer, was announced in May 1989 (to take effect as from September 1989).

Among the regulatory issues to be resolved were the scope (coverage) of price control, and whether there should be a single price control or separate controls on distribution and supply. There also surfaced the possible regulation of initial contracts between successor generators and distribution businesses.<sup>15</sup> The main issues here were the duration of contracts and the level of prices, on which industry views differed markedly.<sup>16</sup>

A seminar on Regulation on 6 July 1988, attended by the Department's Ministers, seemed to settle some of these issues. Price control would be applied to all customers. Initial contracts would be for 5 to 10 years. Aggregate revenue from these contracts should be constrained so that there was no discontinuity with the Bulk Supply Tariff. (7.33) (The Bulk Supply Tariff was the basis on which the CEGB sold electricity to the Area Boards.) But much remained to be resolved. Moreover, views differed within the Department and between its advisors. (7.35-7.36)

On 29 September 1988 the Secretary of State proposed the way ahead to his ministerial colleagues. Reversing the July decision, regulation of electricity supply would be limited to prices in the tariff market. (7.38) The concept of separate price formulae applying to the distribution tariff and to the price of electricity supplied "won favour". Initial contracts would be limited to 10 years except for nuclear stations. Distribution companies would also be limited to owning no more than 15% of their contracted capacity.

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<sup>14</sup> After that would be flotation of the distribution companies in Spring 1990, the larger generator (Big G) in Autumn 1990 and the smaller one (Little G) in Spring 1991. (6.39)

<sup>15</sup> In principle the contracts were for negotiation between the CEGB and the Area Boards. But the Department was concerned to avoid unjustified price increases arising simply from privatization.

<sup>16</sup> The Area Boards were concerned that the CEGB prices were excessive, and that the two CEGB successor generating companies might discriminate by loading the Area Boards with high cost capacity charges while offering contracts at marginal cost to large customers. The CEGB was arguing for contracts to provide capacity payments for the remaining life of its stations, and for freedom to allocate capacity between distribution companies and large customers. It said that, with shorter contracts, flotation proceeds would be reduced unless capacity charges were appropriately increased, and when the time came to renegotiate the contracts, distribution companies would prefer to bring in new entrants or establish their own capacity. (7.21-7.24)

The Chancellor was broadly content, but (with a view to flotation proceeds) had concerns about profits in view of the surplus capacity, and suggested the possibility of longer contracts than 10 years. The Trade and Industry Secretary was more concerned about competition and prices, and preferred contracts shorter than 10 years. (7.46)

The Secretary of State responded on 14 November 1988. He noted that the industry was now proposing two types of contract (see below) to deal with the problem of surplus capacity. He accepted the possibility of “some initial contracts of up to 15 years to provide stability for some time after flotation”. (7. 49) After some further discussion, the Secretary of State circulated draft licenses in December 1988, implementing the policy decisions in his letters of September and November.

## **8. Contract negotiations in 1988**

This apparent progress does not reveal the extent of the differences of view that were emerging during this period. Thinking on contracts evolved as the parties began to come to terms with the implications of competition in supply.

Progress on contracts during 1988 was hampered by the Area Boards’ worries about the opportunity for generators to pick off large industrial customers, particularly given a surplus of generating capacity. To mix the metaphors in vogue, ‘cherry picking’ by the generators would result in demand ‘walking away’ from the distributors, leaving them with ‘stranded’ contracts and investment. A number of ways of dealing with or preventing ‘cherry picking’ were canvassed, resulting in much argument between the two sides and in justifications to the Department of their positions. (9.03)

The CEGB put forward two contractual solutions. In the contract market, distribution companies’ contracts, with those large customers whom they feared might be poached, could be back-to-back with contracts with generators. In the tariff market, contracts with generators would include some provision for ‘winding-down’ the distribution companies’ obligation to buy capacity and energy if generators began poaching customers. The Area Boards were not attracted to these solutions. Wind-down failed to address their concern about the proper level of electricity prices. Back-to-back contracts would hardly be practicable as they would need to be in place for all customers above 1MW (compared with the CEGB’s suggestion of nearer 10MW). (9.04)

The Area Boards responded to the CEGB by proposing a ‘two-tier’ approach to contracting, involving the concept of ‘net-back’ or ‘spot-price’ contracts.

A substantial amount of capacity would be contracted for at prices approximating to present Bulk Supply Tariff levels. For the remainder of the capacity required, the capacity element of the contract would be determined retrospectively by reference to system marginal price. These

'net-back' contracts would enable distribution companies to offer prices to large customers sufficiently low to remove the threat of poaching by the generators. (9.05)

The Area Boards also suggested the possibility of "a temporary limitation on grant of second-tier licenses to supply customers below a certain size". (9.06)

The CEEB initially argued strongly against the net-back contracts. But by December 1988 the CEEB and the Boards had agreed on the broad principles of the contracts. There was still some disagreement over the size of the net-back tranche and the duration of such contracts, but the way ahead seemed clear.<sup>17</sup>

## **9. The first contract package: July 1989**

Despite the apparent agreement, a number of important issues needed to be resolved. The implications for coal privatization also needed to be considered, and Coal Division was becoming very concerned about the possible magnitude of the net-back tranche. (21.04) By May 1989 it had become apparent that decisions on contracts were urgently needed if the timetable was to be met. Following a seminar with the Department and advisers, on 14 June the Secretary of State sent the Prime Minister a paper on Electricity Contracts, Prices and Proceeds. (21.18)

The paper reflected a greater emphasis on competition. Competition in supply would be implemented at Vesting, despite the preferences of the Area Boards. (21.20) There would be life-of-station contracts for nuclear, with the additional costs over and above those of fossil plants being financed by a levy on all customers. There was a new approach to deal with the concerns about stranded contracts. Instead of long-term contracts (up to 15 years) with provisions for winding down (as advocated by the CEEB), or two-tier contracts with a tranche of net-back/spot contracts (as advocated by the Area Boards), the initial contracts for fossil generation would all be for five years and the Area Boards would have options to terminate 10% of these contracts every six months (in effect, their minimum duration would range from six months to five years). This would also benefit independent generators by preventing the two main generators from tying up the market on long-term contracts.

Each fossil-fired generating set would receive a market-related price equivalent to the price expected to be offered by a new entrant generator. This amounted to a 10% reduction on the Bulk Supply Tariff. "The Department's financial advisers believed that a contractual package based on broadly competitive prices provided the only sound basis for flotation if competition was to be introduced". (21.21)

The price estimates assumed British Coal price moving to world coal prices in five years, with a phased reduction in the annual volume purchased. This would

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<sup>17</sup> "The generators were offering 10% of capacity and a [net-back] contract length of three years. The Area Boards were seeking 20% and five to eight years. (9.07) It was agreed that the generators would offer 'indicative' contract prices by the end of January 1989 on the assumption of a 15% tranche of net-back contracts". (9.08) A timetable for negotiating contracts was also agreed.

help to secure the future of British Coal. Additional measures were suggested for limiting the increase in prices to industrial customers. With these, and the introduction of the nuclear levy, average prices to domestic and commercial customers would rise by only about the rate of inflation.

Ministers including the Prime Minister broadly supported the package, albeit with some reservations about prices (some considered them too high, others too low). The Prime Minister was concerned about the impact on pits worked by members of the Union of Democratic Mineworkers (UDM), who had stayed at work during the coal strike. (21.25) The package was agreed on 18 July 1989. The *History* makes no reference to discussions with the industry, let alone agreement. This would turn out to be important. Nonetheless, the industry reportedly accepted the package with some reservations, though British Coal was aggrieved.<sup>18</sup>

The package meant that retail competition would start at Vesting, then scheduled for 1 January 1990, only five months hence. There was no restriction on the extent and nature of such competition. Although the package referred explicitly only to large customers, this seemed to include customers with a maximum demand over 1 MW. There was no statutory or licence barrier to competition to supply smaller customers as and when the companies or competitors thought it worthwhile to do so.

## **10. Rethinking: August to September 1989**

In retrospect, this seems to have been a high point for the prospects of retail competition. Events were soon to undermine these expectations. For example, as a result of further work on nuclear, the costs and risks of the older Magnox stations became increasingly apparent. On 24 July 1989, his last day as Secretary of State, Cecil Parkinson explained that he was withdrawing the Magnox stations from the privatization. (20.39) Eventually, on 9 November, the remaining nuclear stations were pulled from the privatization. (20.40-20.90)<sup>19</sup>

On taking up his appointment, the new Secretary of State John Wakeham was concerned to discover that all was not what it seemed. Progress was behind schedule. Vesting by 1 January 1990 had become unrealistic, as had flotation in Spring 1990. In September he announced a revised timetable: Vesting on 31 March 1990 and flotation of the distribution companies in Autumn 1990 followed by the two generating companies in the first half of 1991.

This in itself would have meant only a three month delay in the opening of full retail competition. However, two other aspects of the July 1989 arrangements - the two-Pool system and the first contract package - soon began to unravel.

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<sup>18</sup> British Coal was concerned at having been kept in the dark about the package, and about the proposed tapering to world prices. The company continued to hold out for a ten year contract for the greater part of its supplies.

<sup>19</sup> A week later Lord Marshall resigned the Chairmanship of the CEGB and his position as Chairman-designate of National Power (formerly Big G). (20.92) It has been suggested to me that he was intransigent and unreceptive to negotiation, and that his disappearance opened the door to all the industry players getting to a workable solution with all the various compromises that were needed.

During the first half of 1989, the CEEB and Area Boards had been working on the basis of a two-Pool system, involving a Generators' G Pool and Distributors' D Pool.<sup>20</sup> As discussions developed, the Area Boards became concerned that this approach would lead to the loss of their largest customers, since the generators could bypass the D Pool and sell direct. (21.12) The generators, for their part, were concerned that the D Pool with its attempt to mirror the actual dispatch of plant via detailed contracts amounted effectively to the leasing of plant to the distributors. This would also be complex, inefficient and unduly restrictive on the generators and on large users wanting load management terms. There was a question whether the proposed rules on contracts were pro-competitive or anti-competitive. Area Boards found difficulty in producing a less restrictive solution.<sup>21</sup> At the beginning of August 1989 they came up with a completely revised single Pool approach: a Unified Settlements System.

This in itself was not a problem for the Department's policy – indeed, the Department saw advantages in the Unified Pool proposal. However, there was more. 'Truly open competition' in retail supply presented a problem for the industry.

At about the same time [early August 1989], Mr Duncan Ross, Chairman of Southern Electric, wrote to Mr Guinness [Department of Energy] about the basic issues between generators and distributors. He believed that the generators were concerned that in a world of truly open competition there would be a severe risk of generating capacity failing to be adequately remunerated on a long term basis. The Area Boards' new proposal for a unified pool did not itself address this concern. Mr Ross suggested that there were only two ways of addressing it:

Either

- 1) long term contracts between distributors and generators, with both capacity remuneration and fixed prices for energy, allied to a distributors' monopoly over supply to regulated customers within their licensed areas;

or

- 2) open competition in supply, with a flotation value for the generators reflecting the resultant volatility of profits.

The Area Boards believed that it could well be possible to reach agreement with the generators on pooling, settlement, contracts etc, on the basis of option 1), but option 2) would require the Department to intervene strongly. (22.01)

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<sup>20</sup> The generators' G Pool would allow generators to trade so as to meet their contractual obligations at lowest cost. The distributors' D Pool would allow the distribution companies to trade their contract entitlements so as to meet demand at the lowest contract price.

<sup>21</sup> In May 1989 the Area Boards had tabled proposals involving 'nine rules' governing pooled and unpooled contracts. In July the Secretary of State rejected these proposals as too restrictive on the nature of contracts. He asked the industry "to develop the two-Pool approach in accordance with three principles which any pooling, contractual and regulatory arrangements should satisfy", and also indicated that "he was willing to consider some restrictions on the generators' freedom to supply customers direct". (21.17) The Area Boards concluded that the two-Pool approach could not be satisfactorily adapted to comply with the Secretary of State's objectives.

The generators confirmed their concerns.<sup>22</sup> They endorsed the proposed two alternative ways in which their concerns could be allayed.

To put the issue another way, the 'broadly competitive contract prices' proposed by the Department and its financial advisers in July 1989 seem to have been based on calculations of a long run new entry price. In contrast, the generators and Area Boards argued that the perceived excess capacity at the time meant that, in the short run, competitive prices could well be below that level.

For the Department, both options presented problems.

The difficulty with a) was that the Area Boards would refuse to sign long-term contracts without a monopoly of some part of the market. (It was thought this [monopoly] would be very unattractive to Professor Littlechild, the No. 10 Policy Unit and possibly to DTI and the European Commission.) The difficulty with b) was that it could make the generators unfloatable, would greatly reduce proceeds, could require cash injections into the generators' balance sheets and would not enable them to sign long-term high-priced contracts with British Coal. (22.03)

At the beginning of September, the Department recommended that the industry should proceed on the basis of the single Pool. There should be further analysis of the viability of the generators depending on the extent of long-term contracts, and an assessment of the Area Boards' argument that they could only accept long-term contracts if they had a monopoly of part of their market. The Secretary of State agreed. But the Department was overtaken by events.

## **11. The industry proposal: September 1989**

The generators and distributors scented a solution to their problems, and were working faster than the Department's processes envisaged. They accepted competition in supply above 1 MW but not below. On 6 September they proposed a set of contracts agreeable to both sets of parties. The key features were a monopoly franchise for each Area Board for customers in its area with maximum demand up to 1 MW, covering about 70% of the total market<sup>23</sup>; long term contracts with fossil stations for supply to the franchise market (average 10 years, maximum 15 years), with a tapering surcharge to British Coal; short term contracts (6 month to 5 years) for at least half the non-franchise market and spot price purchases for the balance; and restrictions on the generating companies selling direct into the non-franchise supply market (in aggregate, not more than

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<sup>22</sup> "[T]hey were worried that it would encourage distributors and other customers to buy from them on a spot basis only. Given the surplus of capacity, the spot price would be low. In addition, low spot prices for sale of electricity would be inconsistent with high prices on a long-term basis for British Coal, which the Government might want to insist on. Also, low spot prices would not fund FGD investment." (22.03) Flue Gas Desulphurisation (FGD) was required in order to clean up the emissions of coal-fired power stations.

<sup>23</sup> Henney (1994 p. 116) says that the package envisaged that "competition would be limited to customers above 10 MW for five years then extended to customers above 5 MW". That would have been even more restrictive than the package described in the *History*.



15% of their total capacity and not more than 15% of any one Area Board market). (22.05)

Generators and distributors were united in the belief that this package would remove sources of uncertainty, facilitate rapid progress on contracts and allied matters, preserve substantial competition and permit successful flotations. (22.05)

## **12. The Department's dilemma**

Given the strong disagreements between Area Boards and generators, the prospect of agreement within the industry must have been attractive. However, the Department was soon faced with concerns about this proposal. The Prime Minister's office noted "the crucial importance of achieving genuine competition in contractual and operating arrangements, so that the consumer secured proper benefits from privatisation". (22.06)<sup>24</sup>

However, the Department was reluctant to reject the proposal. The Secretary of State replied to the Prime Minister's office on 12 September, suggesting that "achievement of the prime objective of privatisation might mean some modification of other objectives in the short term". (22.07) While the industry's recent proposals "represented a major initial limitation of the competitive structure which Mr Parkinson had agreed with officials in July, the industry maintained that they were indispensable to privatisation proceeding on the current timetable". And they had other advantages.<sup>25</sup>

The Secretary of State met with the Prime Minister on 13 September. She reaffirmed that achieving privatization had to be the first priority. "At the same time it was important to avoid the extent of competition being over-diluted, resulting in a rerun of the British Gas privatisation. But she recognised that some degree of compromise on competition was likely to be necessary in striking the overall balance." (22.08)

## **13. The Department's response**

The Department noted that these proposals "were unique in that it was the first time that the Area Boards and the generators had agreed on the principles on which the new contractual, operating and settlement regime should be based". Although the industry was nationalized, it was statutorily run at 'arm's length' from government. All the parties therefore had to be satisfied before signing the contracts (and personally signing the prospectus statements) on which the new regime depended. Hence it was not feasible to contemplate imposing a solution

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<sup>24</sup> In addition, the Trade and Industry Secretary "was concerned about reports that the industry wanted to have long-term supply contracts and a distributors' monopoly of small customers. This would run counter to the pro-competitive approach agreed in the summer. A move to long-term initial contracts would jeopardise the chances of proper competition developing and would be especially hard on emerging private generators". (22.07)

<sup>25</sup> "The proposals retained competition in generation; were likely to be welcomed by independent generators; and could well make it easier to accommodate the costs of reducing sulphur emissions. Longer-term contracts with distributors would enable the generators to enter into longer-term commitments to British Coal." (22.07).

on the industry. The Department therefore advised that “some deal with the industry was essential if privatisation was to be achieved during the present Parliament; but that an attempt ought to be made to limit the restriction on competition that the proposals represented”. This might be with a smaller franchise market, a shorter franchise period, or shorter initial contracts. (22.09) This approach perhaps reflected the inclinations of the new Secretary of State, who had a reputation as a ‘fixer’ of difficult political problems.

Meanwhile other departments reaffirmed their concerns about competition. (22.10) The Department had “extensive discussions with all sides of the industry and two discussions with Professor Littlechild”. On 22 September it identified two options. (22.11, 22.12)

- The first option involved a five year restriction on competition in supply to premises consuming less than 1 MW. This would be reviewed at the end of five years. If the Government decided to remove the restriction, the transition to a fully competitive market would be phased over three years.
- The second option involved a three year restriction on competition in supply to premises consuming less than 1 MW; after the three years were up, a phased reduction of the 1 MW limitation to 0.1 MW (100 kW) over the next two years; the 0.1 MW limitation being phased out altogether over a further three years.

Whereas the first option provided the *possibility* of competition for all customers within 8 years, the second provided a *commitment* to allow the phased introduction of such competition over the same period. In other respects, especially contracts, the two options were essentially the same.<sup>26</sup> The main difference from the industry proposal was that long term contracts would cover 50% rather than 70% of the total market.

The Department envisaged that the industry would accept the first option but that Professor Littlechild would not.<sup>27</sup> PowerGen was relaxed about the second option but the Area Board chairmen and National Power reacted adversely. Professor Littlechild responded favourably. The Department recommended that the Secretary of State should seek to persuade the industry to accept the second option, on the same basis as they put forward their own proposals, “i.e. that they would cooperate constructively and effectively to deliver privatisation during the present Parliament”, otherwise the only proposal remaining on the table would be that agreed by Ministers in July.

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<sup>26</sup> They both envisaged a) life-of-station contracts for nuclear (which had already been agreed) and ten to fifteen year contracts for 12 GW of fossil-fuel capacity. In total, these longer term contracts would cover about 50% of the total market; b) the remainder of the initial franchise market (about 20% of the total market) would be met by shorter-term (three to five year) contracts; c) the initial non-franchise market (about 30% of the total market) being met by a mixture of spot and six month to five year contracts, as proposed by the industry; and d) a limit of 15% on the generators’ aggregate direct sales in any one distributor’s licensed area. (22.11) The reduction in the franchise to 0.1 MW would extend competition to about 50,000 customers accounting for about 50 % of the total market.

<sup>27</sup> “He thought that a five year monopoly in the market below 1 MW would provoke much criticism, particularly on the part of larger retailers and other commercial operators who would be excluded for some time from the benefits of competition in supply. The Department’s advisers considered that opposition from Professor Littlechild, or even reluctant acquiescence, would unsettle investors and lead to lower proceeds.” (22.11) On 25 September Professor Littlechild confirmed his strong reservations about the industry’s proposals. (22.13)

At his crucial meeting with the industry Chairmen on 25 September, the Secretary of State explained why the industry's proposal of 6 September presented him with difficulties: he did not believe he could persuade colleagues to accept it, there would be considerable difficulties with the European Commission, and difficulties, too, with the DGES. He was prepared to put to colleagues the alternative proposal tabled by the Department [the second option] if he could tell them the industry was united behind it. (22.14)

The industry Chairmen raised various objections, which were generally countered.<sup>28</sup> Nevertheless, as the industry appeared to be dissatisfied with the Department's proposal, the Secretary of State asked the Chairmen to come forward with a modified proposal by the end of the day, otherwise he would take the Department's proposal unmodified to the Prime Minister.

#### **14. The industry's modified proposal**

The Chairmen worked on this issue during the afternoon and presented a package which the Secretary of State believed there was a reasonable chance of colleagues accepting. (22.14)

The modified proposal had the following features:

- (a) a four year limitation on the issue of second-tier supply licences for supply to premises taking 1 MW or less
- (b) a further four year limitation on issue of second-tier licences for supply to premises taking 0.1 MW or less
- (c) thereafter no limit on the issue of second-tier licences
- (d) life of station contracts for supply from nuclear stations
- (e) four to eight year contracts for 12 GW of supply from fossil-fuelled stations, equivalent to the extent of the distributors' monopoly franchise
- (f) the distributors to secure the balance of their requirements under contracts with the generators of up to five years
- (g) during the first four years, National Power and PowerGen would, in aggregate, be limited to supplying no more than 15% of the demand in any one distributor's territory. This limit would be raised to 25% for the next four years and then be completely lifted. (22.15 underlining in original)

Professor Littlechild argued for a faster reduction in the distributors' monopoly.<sup>29</sup> Nonetheless, on 26 September 1989 the Secretary of State

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<sup>28</sup> E.g. "The Area Boards said that ... under the Department's proposal, they would not be able to offer independent generators sufficiently long-term contracts to make investment worthwhile, though this might be different if the distributors were given a permanent monopoly below 0.1 MW. The Secretary of State said that he would not be able to secure colleagues' agreement to a permanent franchise." (22.14)

<sup>29</sup> Via one or more of the following: "removal of the 1 MW to 0.1 MW franchise within two rather than four years; the DGES to have discretion to allow aggregation of premises; and the timetable for removal of monopoly to be reviewed by the DGES after two years". (22.16)

recommended the industry's modified proposals to his colleagues. They gave a qualified acceptance, inviting him to seek a shorter transitional period (six rather than eight years). (22.24) The Department advised that this would make the coal contract negotiations very difficult. The Secretary of State wrote to the industry chairmen on 29 September 1989, accepting the package they had put forward. He described the discussions as "the most productive since the Electricity Act was passed". (22.26)

## **15. Subsequent contracts and prices**

As the *History* remarks, "there remained the enormous task of translating the principles and framework now agreed into contracts, codes and agreements" (22.28) This had to be complete by Vesting on 31 March 1990, just six months hence.

In particular, the coal and electricity contracts that had driven the supply competition timetable had to be negotiated. The Secretary of State indicated that "he had accepted the eight year limitation on competition within the electricity industry because that would make it easier for long-term coal contracts to be signed". (26.03) In the event, British Coal and the generators were unable to reach agreement on the envisaged four to eight year contracts. The final contract package brokered by the Secretary of State was limited to three years. British Coal declined to sign longer contracts on the terms on offer. This in turn led to three year contracts between generators and distributors, despite the franchise having been agreed at eight years. (26.24) In December 1989 the contract package was modified accordingly. (26.12, 26.13, 26.25)

The Government considered it important to assess the implications for prices.<sup>30</sup> Steps were taken to reduce the projected price increases to large users to a politically acceptable level, notably by rebalancing between franchise and non-franchise customers. (26.22-26.38) The Area Boards eventually announced average price increases of 9.0% nominal for franchise customers (presented as below the rate of inflation, then 9.4%) and average price reductions of 8.47% nominal for non-franchise customers.

## **16. The broader context, the evolution of thinking and the learning process**

The Government 'created' the market for retail electricity supply in the sense that it removed the statutory monopoly of the Area Boards. This step has to be seen in its broader context. The Government's aim was to turn a state monopoly as far as possible into a privately owned and competitive market. This necessitated restructuring the industry, creating competition in generation and in supply, creating a wholesale spot market (the Pool), writing initial contracts,

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<sup>30</sup> Calculations just before the December contract package suggested a 6% to 8% nominal price increase for domestic [residential] consumers, reductions in real terms for the majority of commercial and industrial customers, but price increases of 15% nominal for large users and up to 30% nominal for the dozen or so very large users. "Such increases were clearly unacceptable." (26.21)

setting up a regulatory framework, and so on. There were also many goals to achieve: a better deal for customers, ensuring security of supply, taking forward the nuclear program, obtaining value from the sale of the industry, and completing the privatization within the lifetime of the 1987 Parliament – and enabling the subsequent transition to a privatized and competitive UK coal industry as well. Creating a retail electricity market was important, but it was only a part of the total picture, and could not be allowed to jeopardize the other objectives.

The Department's thinking on what creating this retail market would mean, and therefore how to do it, evidently went through several significantly different stages.

- The *White Paper* in February 1988 saw supply competition as hardly worth mentioning, irrelevant other than for a few large users.
- Even by December 1988 it was still a minor issue: the Government envisaged long-term (5 to 15 year) contracts in the industry, with any concerns about stranded contracts being met by a small tranche of spot-price contracts.
- By July 1989 the Government attached greater importance to both wholesale and retail competition. It proposed to remove the retail monopoly immediately and entirely. Instead of long-term contracts, short-term (6 months to 5 year) contracts and options to terminate contracts would offset the risks to investors and facilitate new entry into generation.
- The industry argued that the resulting contract prices (and flotation proceeds) would be unduly low, and would not facilitate coal privatization. Generators and distribution companies proposed a package that they had agreed between themselves, limiting retail competition to customers over 1 MW, with a franchise monopoly below 1 MW enabling long-term contracts up to 15 years.
- The Government was now torn. It was concerned to ensure proceeds, investment and coal privatization. And it felt unable to dictate terms to the industry parties because it needed their acceptance of the contracts that would underpin privatization. Nevertheless, the continuation of a franchise monopoly was no longer acceptable.
- The Government therefore accepted the principle of a temporary franchise monopoly but insisted on a transition to full retail competition. In September 1989 agreement was reached on a phased three-stage opening, with provision for contracts of four and eight years to match this.

There was certainly a learning process.<sup>31</sup> Henney (1994) brings out well the particular structure to the process. "The parties to the negotiation were grappling with how to break the traditional 'utility deal' and reconstruct relationships in a competitive manner". (p. 104) Some preferred the 'utility deal',

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<sup>31</sup> "[E]conomic policy making is a dynamic game, whose conditions are uncertain and changing, and whose rules are at least partially made up by the participants as they go along." (Dixit 1996 p. 30)

others preferred the competitive model.<sup>32</sup> The Government in principle preferred the competitive model – but also wanted the concomitants of a utility deal (subsidies for coal and nuclear power and an obligation to supply) that were ultimately inconsistent with competition. A learning process was inevitable, on the part of all concerned.<sup>33</sup> This was particularly true with respect to the significance of retail competition.

Above all few understood the extent to which introducing competition in supply – in addition to competition in generation – changed the fundamental risk allocation and hence economics of the industry, and was opening Pandora's box. Initially competition in supply was treated like an add-on, and it took a long time for people to appreciate that it was central to the system, and that many of the proposals to restrict competition would unwind like a ball of string. It took some time for the profound significance of competition in supply to be fully understood, and that among other things it had fundamental financial implications and made traditional capacity planning (indeed any form of decentralised capacity planning) impossible, and for people to appreciate that competition in supply was the most radical part of the proposed new system. (Henney 1994 pp. 93-4)

## **17. A negotiated settlement?**

The Department of Energy was leading the electricity privatization, but eventually found itself not in a position to dictate terms. It needed to gain the agreement not only of other Departments, but importantly of the relevant economic and political actors. This included especially the generators and Area Boards, who were incumbents in their own markets but potential entrants into the markets of the other parties. As nationalised industries whose agreement was needed to sign contracts and the privatization prospectus, they were not pawns of the Government, but ultimately became 'veto players' in the 'game'. However, they were reluctant to exercise veto power insofar as they too wished to bring about a timely privatization.

It became apparent that the solution proposed by the Department in July 1989, and agreed by ministers, was not viable. The parties were unable to reach agreement within that framework, at least not without jeopardising proceeds, timely completion and coal contracts. The breakthrough was in effect a

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<sup>32</sup> "Throughout this phase of the work and indeed up to the agreement on the contractual package in September 1989, there was continual conflict between the proponents (to exaggerate) of the 'competitive model' (who included the government), who advocated open access for all customers, a rapid move to market prices, shorter term contracts between the generators and the RECs, ready access for new entrants, and a low flotation value for National Power and PowerGen, and the proponents of the 'franchise model'. They advocated limiting competition to customers with a load over 10 MW and the retention of a permanent franchise for smaller customers, relatively higher electricity prices, longer contracts between the generators and RECs (which could if necessary incorporate subsidies for nuclear power and coal and perforce restricted access for new entrant generators), and a higher valuation for National Power and PowerGen." (Henney 1994 p. 93)

<sup>33</sup> "People had to go down the traditional path to see that it got them nowhere; it took time to change from conventional electricity supply industry thinking the world over to more 'normal' commercial thinking. The people involved were creating a whole new way of doing business – it was not surprising that the learning process was somewhat confused and tortuous." (Henney 1994 p. 105)

negotiated settlement, a package comprising only a partial opening to competition but also a mix of long-term and short-term contracts negotiated between the industry parties themselves. The latter were no doubt interested to protect their markets from competition, but they were also offering deliverability of the Government's policy as a whole.

Remarkably, in view of the stance just a year earlier, the Government insisted on the parties modifying the agreed package to meet the concerns of ministers and the DGES about retail competition. As Helm (2004) observes, the point of an agreed timetable for opening the whole of the market was to commit not only the industry and the regulator but also subsequent governments. The choice made in September 1989 turned out to be critical. Suppose the industry's initial proposal had been accepted, or the Department's first option (review of the retail monopoly after five years) had been chosen. The political pressures posed by the coal industry in the mid-1990s would undoubtedly have led to deferral or abandonment of the prospect of full competition and of the ending of the coal subsidies. It would have saddled more customers with the costs of high-priced contracts for a longer period of time. Again, when some distribution companies argued against full market opening after the new (Labour) Government was elected in 1997, the committed timetable provided a defense against such opportunism.

Was the decision to insist on a timetable inevitable? Was it independent of the personalities involved? It seems likely that there would have been pressure to allow retail competition for the largest users, maybe even as far as industrial users over 1 MW. But would the extent of retail competition have gone much further without key ministers (and advisers) as committed to the principle of competition as Cecil Parkinson, Margaret Thatcher (and Sir Alan Walters), Nigel Lawson and Lord Young? Or without a prospective DGES who had actually proposed the novel policy of full retail competition some five years earlier?

In the event, the longer contracts specified in the package were not delivered. A critical interested party, British Coal, was not a party to the package. Should it have been involved in this negotiation? If so, it is not clear that agreement would have been reached consistent with the Government's emphasis on competition. The eight year package was not irrelevant: when the three year coal contracts came up for renewal the Government took full advantage of the remaining franchise to broker new contracts to cope with a difficult political situation and to enable coal privatization. By the same token the Government was constrained by the timetable with respect to both quantity and duration of subsidy.

In the end, some phasing of competition was not necessarily a bad idea, even from the perspective of those who argued for the 'competitive model'. It enabled electricity privatization to take place on time, with manageable risks to the companies, and later coal privatization. It allowed time for all parties to learn from experience, and for later regulatory provisions (e.g. metering, profiling and data transfer) to make retail competition effective for residential users. Against this, the phasing did force medium-to-large users (for four years), and smaller

and residential customers (for eight years) to bear a very considerable burden of subsidizing the British coal industry.

In contrast to all the agonizing over the design, duration and pricing of initial contracts, the subsequent competitive market process in the UK has so far selected vertical integration between generation and supply, rather than long-term contracts, as the main means of survival. Ironically, the early contributors to the discussion all dismissed the possibility of vertically integrated regional power boards. Yet that concept is perhaps closest to the eventual outcome today (albeit without the regional element, except in Scotland). If the concept of retail competition had been better elaborated and understood in the 1980s, power boards might have received more sympathetic consideration, though any regional nature would not have been so conducive to effective competition.

## **18. Was it worth it?**

The question is inevitably asked: was it worth it? Did the benefits of full retail competition outweigh the costs? There is not space to address this question fully here, but a few remarks may be in order.

Non-franchise customers fared very well when the market opened.<sup>34</sup> Generators proved keen to offer attractive terms and large users proved keen to respond. Within the first month or so, 28% of non-franchise (over 1 MW) customers, accounting for 43% of non-franchise load, had signed up for an alternative (second tier) supplier. Within eight years these proportions had increased to 63% and 75%, respectively (Offer 1997 p. 28). In 1994, medium-sized industrial users (with maximum demand over 0.1 MW or 100 kW) showed that they too were willing to switch supplier.<sup>35</sup> It does not seem to be disputed that retail competition has been of benefit to industrial and commercial users.

Would residential customers and other small users be interested in competition in supply? Some in the Department and the industry had doubted it.<sup>36</sup> But in 1998, when they were at last allowed a choice, residential customers moved to new competing suppliers at the rate of more than 1% per month. A decade later, more than half the residential customers in the UK are supplied by non-incumbent suppliers.

But numbers of customers changing supplier is only one aspect. Are the benefits to residential customers worth the costs involved? In the UK today there is particular concern whether retail profit margins are excessive and whether

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<sup>34</sup> "A survey of industrial users on behalf of the Major Energy Users Council reported that for the year ending March 1991, 76% of consumers with sites consuming 1 MW or more had experienced price reductions of at least 10%, and 31% had had reductions of over 20%. (*Power in Europe* 18 July 1991)" (26.38)

<sup>35</sup> In 1994/5 some 25% of 100 kW customers, accounting for 30% of the total 100 kW load, switched supplier. By 1997/8 those proportions had increased to 41% and 53% respectively (Offer 1997).

<sup>36</sup> One of the most senior Area Board chairmen had responsibility for coordinating the arrangements for retail competition. I told him that I could envisage domestic (residential) customers choosing their own electricity supplier, perhaps selecting from entries in the Yellow Pages telephone book. "It will never happen" he said firmly, "It will never happen".



prices follow wholesale prices down as quickly as they should do. Some call for reintroducing regulation of retail prices.

Various attempts have been made to analyze these costs and benefits, and to construct counterfactual prices (e.g. Green and McDaniel 1998, Littlechild 2002, Newbery 2006, Defeuilly 2009, Littlechild 2009). Just two brief observations here. First, retail competition means that customers do not have to 'take what they are given', or rely on regulation being able and willing to discover what different customers want and to identify and enforce a 'fair' or 'competitive' price. It gives all customers (and suppliers) the ability to act for themselves. Each individual customer is able to choose the combination of price, risk, duration of contract and other terms that best suits that customer's needs. The variety can be remarkable (e.g. Littlechild 2006).

Second, in assessing the level of retail prices, the level of wholesale price that is observed in the market should not be taken as given. The question is what that wholesale price would have been in the absence of retail competition for residential customers. The relevant comparison is with a monopoly franchise covering between one third and one half the total market, with associated investments, contracts, wholesale and retail prices determined by government and/or regulator rather than by the competitive market. The evidence from the process of opening the UK retail market, and from experience elsewhere, does not suggest that the interests of customers would be the only or most important consideration. This is not to say that other considerations - related to fuel mix, climate change or affordability, for example - cannot be justified as a matter of public policy. But with full retail competition any restrictions on the competitive market now have to be justified explicitly and are thereby subject to more informed analysis, costing and debate. That is surely a significant benefit of retail competition.

Is the British approach to creating a retail market a model for others? Maybe not, even though the concept of a timetable has set a precedent followed by many governments worldwide. Each country will have its own specific issues to address. However, the multi-faceted nature of the market, the multiple goals of policy, the somewhat unpredictable process of balancing conflicting objectives and emerging practical constraints, the substantial learning over time, the role of negotiated agreement within the industry, and the delivery of some but not all the initial aims of policy – all this may not be unrepresentative of how governments actually operate, including in creating markets. What was perhaps distinctive at a critical time was the commitment to competition exhibited by so the leading actors in this particular drama. And, I would argue, with justification.

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## **Creation of Market in Retail Electricity Supply: Timeline of Events**

**1947, 1957** Electricity Acts creating CEBG and Area Boards with regional monopolies

**1979** May General Election, conservative victory

**1982** June Oil and Gas (Enterprise) Act liberalising gas market and enabling competition through common carriage

**1983**

May Energy Act extending the same principles to electricity

May Coopers and Lybrand report to Department of Energy proposing breakup of CEBG to enable competition in generation but continued monopoly in supply

May Sir Walter Marshall letter opposing breakup of CEBG and proposing 'two company solution' with competition to supply large users

June General Election, Conservative victory

November Littlechild & Beesley paper to Treasury proposing full retail competition

**1987**

March Henney monograph for CPS advocating restructuring of CEBG and competition to supply large users

April Department report to Mr Walker noting support for 'two company solution'

June Conservative Party Manifesto commitment to electricity privatization

October General Election, Conservative victory, Mr Parkinson appointed as Secretary of State for Energy

September Chequers seminar

November Nuneham Park seminar

**1988**

February White Paper *Privatising Electricity*

March Department paper (to industry) on structure of regulation

July Department seminar on regulation

September Mr Parkinson's proposals on regulation

November introduction of the Electricity Bill

December draft licences

**1989**

January Divisionalisation of CEBG

March embryo Office of Electricity Regulation (Offer)

May appointment of Director General of Electricity Supply announced

June Mr Parkinson's proposals (to PM) on contracts, prices and proceeds

July Magnox nuclear stations withdrawn from privatization

July John Wakeham replaces Cecil Parkinson as Secretary of State for Energy

July Royal Assent to Electricity Act

August Area Boards propose Unified Pool instead of Two Pool system

September appointment of Director General of Electricity Supply effective

September franchise and contract package negotiated and agreed, including 8 year timetable to full retail competition

September decision on revised privatization timetable

November remaining nuclear stations withdrawn from privatization

November agreement between British Coal and generators on initial contracts

December Mr Wakeham's proposals on revised (3 year) contract package, contract prices and nuclear revenue

**1990**

March revised Vesting Day

November Offer for sale of distribution company shares

**1991**

March Offer for sale of 60% of generation company shares